

**Exhibit D**

**Financial Qualifications**

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

Pac-West Telecomm, Inc.  
Stockton, California

We have audited the accompanying consolidated balance sheet of Pac-West Telecomm, Inc. and subsidiaries as of December 31, 2004 and the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity, and cash flows for the year then ended. We have also audited the 2004 Schedule II — Valuation and Qualifying Accounts (the Schedule). The financial statements and the Schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the Schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and Schedule are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and the Schedule, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statement and the Schedule. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pac-West Telecomm, Inc. and subsidiaries at December 31, 2004 and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Also in our opinion, the Schedule presents fairly, in all material respects, the information set forth therein.

/s/ BDO SEIDMAN, LLP

San Francisco, California

February 25, 2005, except for Note 18, which is dated as of March 11, 2005

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders

Pac-West Telecomm, Inc.

We have audited the accompanying consolidated balance sheet of Pac-West Telecomm, Inc. and subsidiaries as of December 31, 2003 and the related consolidated statements of operations and comprehensive income (loss), changes in stockholders' equity and cash flows for each of the years in the two-year period ended December 31, 2003. In connection with our audits of the consolidated financial statements, we have also audited the accompanying financial statement schedule for each of the years in the two-year period ended December 31, 2003. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pac-West Telecomm, Inc. and subsidiaries as of December 31, 2003, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2003, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related 2003 and 2002 information in the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ KPMG LLP

Mountain View, California

February 13, 2004

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**PAC-WEST TELECOMM, INC.**

**CONSOLIDATED BALANCE SHEETS**

**As of December 31, 2004 and 2003**  
(In thousands except share and per share data)

	2004	2003
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 32,265	\$ 34,657
Short-term investments	10,501	—
Trade accounts receivable, net of allowances of \$366 and \$1,560 as of December 31, 2004 and 2003, respectively	12,774	7,713
Prepaid expenses and other current assets	5,316	4,576
Deferred tax assets	—	3,467
Total current assets	60,856	50,413
PROPERTY AND EQUIPMENT, net	43,413	121,211
GOODWILL	119	—
OTHER ASSETS, net	2,664	2,578
Total assets	\$ 107,052	\$ 174,202
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 5,684	\$ 6,098
Current obligations under notes payable and capital leases	2,889	2,606
Accrued interest	2,208	2,096
Other accrued liabilities	12,445	11,696
Deferred revenues	846	594
Total current liabilities	24,072	23,090
SENIOR NOTES	36,102	36,102
NOTES PAYABLE, less current portion	28,285	18,421
CAPITAL LEASES, less current portion	651	191
DEFERRED REVENUES, less current portion	353	467
DEFERRED TAX LIABILITIES	—	3,467
Total liabilities	89,463	81,738
COMMITMENTS AND CONTINGENCIES (Note 9)		
<b>STOCKHOLDERS' EQUITY:</b>		
Common stock, \$0.001 par value:		
Authorized shares — 100,000,000		
Issued and outstanding shares — 36,792,426 and 36,590,532 at December 31, 2004 and 2003, respectively	37	37
Additional paid-in capital	204,540	204,461
Deferred stock compensation	(565)	(758)
Accumulated deficit	(186,309)	(111,276)
Accumulated other comprehensive loss	(114)	—
Total stockholders' equity	17,589	92,464
Total liabilities and stockholders' equity	\$ 107,052	\$ 174,202

See notes to the consolidated financial statements.

**PAC-WEST TELECOMM, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

**AND COMPREHENSIVE INCOME (LOSS)**

For the Years Ended December 31, 2004, 2003 and 2002

(In thousands except per share data)

Years Ended December 31,

	2004	2003	2002
<b>REVENUES</b>			
<b>COSTS AND EXPENSES:</b>			
Network expenses	39,834	36,286	53,525
Selling, general and administrative	58,065	59,217	60,114
Depreciation and amortization	32,565	44,000	40,350
Restructuring charges	516	125	8,620
Impairment of assets	54,898	—	16,621
<b>Total operating expenses</b>	<b>185,878</b>	<b>139,628</b>	<b>179,230</b>
Loss from operations	(61,872)	(4,988)	(15,132)
<b>OTHER (INCOME) EXPENSE:</b>			
Interest expense	12,515	13,520	17,398
Loss (gain) on extinguishment of debt	(409)	(477)	(1,605)
Loss on asset dispositions, net	1,055	30	131
<b>Total other (income) expense, net</b>	<b>13,161</b>	<b>16,762</b>	<b>(17,923)</b>
<b>(LOSS) INCOME BEFORE INCOME TAXES</b>	<b>(75,033)</b>	<b>(21,750)</b>	<b>2,791</b>
<b>(BENEFIT FROM) PROVISION FOR INCOME TAXES</b>	<b>—</b>	<b>(6,500)</b>	<b>745</b>
<b>Net (loss) income</b>	<b>\$ (75,033)</b>	<b>\$ (15,250)</b>	<b>\$ 2,046</b>
<b>NET (LOSS) INCOME PER SHARE:</b>			
Basic	\$ (2.05)	\$ (0.42)	\$ 0.06
Diluted	\$ (2.05)	\$ (0.42)	\$ 0.06
<b>WEIGHTED AVERAGE SHARES OUTSTANDING:</b>			
Basic	36,655	36,481	36,308
Diluted	36,655	36,481	36,334
<b>COMPREHENSIVE (LOSS) INCOME:</b>			
Net (loss) income	\$ (75,033)	\$ (15,250)	\$ 2,046
Unrealized (loss) on investments	(114)	—	(103)
Reclassification of realized gain on sale of investments	—	156	—
<b>Comprehensive (loss) income</b>	<b>\$ (75,147)</b>	<b>\$ (15,094)</b>	<b>\$ 1,943</b>

See notes to the consolidated financial statements.

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PAC-WEST TELECOMM, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2004, 2003 and 2002  
(In thousands)

	Common Stock		Additional Paid-In Capital	Note Receivable from Shareholders	Accumulated (Deficit)	Accumulated Other Comprehensive Income/ (Loss)
	Shares	Amount				
Balance, December 31, 2001	36,148	\$ 36	\$ 183,550	\$ (200)	\$ (98,072)	\$ (53)
Exercise of stock options	223	—	17	—	—	—
Issuance of shares under Employee Stock Purchase Plan	73	—	101	—	—	—
Unrealized loss on investments	—	—	—	—	—	(103)
Amortization of deferred stock compensation	—	—	—	—	—	—
Net income	—	—	—	—	2,046	—
Balance, December 31, 2002	36,444	36	183,668	(200)	(96,026)	(156)
Exercise of stock options	69	1	68	—	—	—
Note receivable from stockholder	—	—	—	200	—	—
Warrants issued with Senior Secured Note	—	—	20,004	—	—	—
Issuance of shares under Employee Stock Purchase Plan	78	—	38	—	—	—
Reclassification of realized gain on sale of investments	—	—	—	—	—	156
Deferred stock compensation	—	—	683	—	—	—
Amortization of deferred stock compensation	—	—	—	—	—	—
Net loss	—	—	—	—	(15,250)	—
Balance, December 31, 2003	36,591	37	204,461	—	(111,276)	—
Exercise of stock options	86	—	40	—	—	—
Issuance of shares under Employee Stock Purchase Plan	115	—	110	—	—	—
Unrealized loss on investments	—	—	—	—	—	(114)
Amortization of deferred stock compensation and other	—	—	8	—	—	—
Deferred financing fees	—	—	(79)	—	—	—
Net loss	—	—	—	—	(75,033)	—
Balance, December 31, 2004	36,792	\$ 37	\$ 204,540	\$ —	\$ (186,309)	\$ (114)

[Additional columns below]

[Continued from above table, first column(s) repeated]

	Deferred Stock Compensation	Total Shareholders' Equity
Balance, December 31, 2001	\$ (190)	\$ 85,071
Exercise of stock options	—	17
Issuance of shares under Employee Stock Purchase Plan	—	101
Unrealized loss on investments	—	(103)
Amortization of deferred stock compensation	104	104
Net income	—	2,046
Balance, December 31, 2002	(86)	87,236
Exercise of stock options	—	69
Note receivable from stockholder	—	200
Warrants issued with Senior Secured Note	—	20,004
Issuance of shares under Employee Stock Purchase Plan	—	38
Reclassification of realized gain on sale of investments	—	156
Deferred stock compensation	(683)	—
Amortization of deferred stock compensation	11	11
Net loss	—	(15,250)
Balance, December 31, 2003	(758)	92,464

Exercise of stock options	—	40
Issuance of shares under Employee Stock Purchase Plan	—	110
Unrealized loss on investments	—	(114)
Amortization of deferred stock compensation and other	193	201
Deferred financing fees	—	(79)
Net loss	—	(75,033)
Balance, December 31, 2004	<u>\$ (565)</u>	<u>\$ 17,589</u>

See notes to the consolidated financial statements.



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PAC-WEST TELECOMM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2004, 2003 and 2002  
(In thousands)

	Years Ended December 31,		
	2004	2003	2002
<b>OPERATING ACTIVITIES:</b>			
Net (loss) income	\$(75,033)	\$(15,250)	\$ 2,046
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	32,565	44,000	40,350
Amortization of deferred financing costs	703	434	693
Amortization of discount on note payable	5,498	156	—
Amortization of deferred stock compensation and other	200	11	104
Impairment of assets	54,898	—	16,621
Non-cash restructuring charges	—	—	3,408
Net loss (gain) on extinguishment of debt	—	3,689	(33,847)
Net loss on asset dispositions	1,055	30	131
Provision for doubtful accounts	(183)	192	1,008
Deferred income tax (benefit) provision	—	(5,246)	668
Other	—	—	1,148
Changes in operating assets and liabilities, net of acquisitions:			
(Increase) decrease in trade accounts receivable	(4,772)	4,719	69
Decrease in income tax receivable	—	—	7,386
(Increase) decrease in prepaid expenses and other current assets	(146)	1,106	(750)
Decrease in other assets	265	31	1,388
(Decrease) in accounts payable	(414)	(4,204)	(1,478)
Increase (decrease) in accrued interest	744	(3,426)	(1,624)
(Decrease) increase in other accrued liabilities	(2,604)	(7,828)	7,321
Net cash provided by operating activities	12,776	18,414	44,642
<b>INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	(7,132)	(4,980)	(19,564)
(Purchases) redemptions of short-term investments, net	(10,615)	29,365	(10,841)
Proceeds from disposal of equipment	148	75	200
Costs of acquisitions, net of cash received	(587)	—	—
Deposits associated with the enterprise customer base sale	3,500	—	—
Net cash (used in) provided by investing activities	(14,686)	24,460	(30,205)
<b>FINANCING ACTIVITIES:</b>			
Payment on senior credit facility	—	—	(10,000)
Proceeds from repayment of note receivable from stockholder	—	200	—
Proceeds from borrowing under note payable	3,322	40,049	35
Repayments on Fiber IRU	—	(4,200)	(13,040)
Repayments on notes payable	(1,048)	(59,015)	(20,657)
Principal payments on capital leases	(2,668)	(8,177)	(6,752)
Payments for deferred financing costs	(237)	(5,205)	(120)
Proceeds from the issuance of common stock	149	81	118
Net cash (used in) financing activities	(482)	(36,267)	(50,416)
Net (decrease) increase in cash and cash equivalents	(2,392)	6,607	(35,979)
<b>CASH AND CASH EQUIVALENTS:</b>			
Beginning of year	34,657	28,050	64,029
End of year	\$ 32,265	\$ 34,657	\$ 28,050
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>			
Cash paid during the year for:			
Interest	\$ 5,584	\$ 16,413	\$ 19,883
Income taxes	\$ —	\$ 161	\$ 7
<b>Non-cash Operating and Financing Activities:</b>			
Prepaid maintenance agreement financed by notes payable	\$ 1,624	\$ —	\$ —
Capitalized interest on Senior Secured Note	\$ 634	\$ —	\$ —
<b>Non-cash Investing and Financing Activities:</b>			
Equipment acquisitions financed by notes payable	\$ 2,075	\$ —	\$ —
Equipment acquisitions on capital lease obligation	\$ 1,376	\$ 765	\$ —

See notes to the consolidated financial statements.

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### **PAC-WEST TELECOMM, INC.**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2004**

#### **1. Summary of Significant Accounting Policies**

##### ***Description of Business***

Pac-West Telecomm, Inc. (the Company) has evolved into a high-value, independent provider of integrated communications solutions that enable communication providers to use our network and services as an alternative to building and maintaining their own network. The Company's customers include Internet service providers, enhanced communications service providers (ESPs) and other direct providers of communication services to business or residential end-users, collectively referred to as service providers, or SPs. In response to our changing business model, on March 11, 2005, we sold the majority of our enterprise customer base to U.S. TelePacific Corp. (TelePacific) while retaining our associated network assets. Under the terms of this transaction, TelePacific acquired certain assets and assumed certain liabilities associated with our Enterprise customers in exchange for \$26.9 million in cash (see Note 18).

##### ***Principles of Consolidation***

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries since the date of acquisition. All intercompany accounts and transactions have been eliminated.

##### ***Critical Accounting Policies***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These assumptions effect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities, and reported amounts of revenues and expenses:

Management considers the following accounting policies to be critical due to the estimation process involved in their calculation:

- revenue recognition;
- provision for doubtful accounts receivable;
- estimated settlements of disputed billings; and
- impairment of long-lived assets.

By their nature, these judgments are subject to uncertainty. Thus, actual results could differ from estimates made and such differences could be material.

*Revenue Recognition.* The Company recognizes revenue when:

- there is persuasive evidence of an arrangement;
- delivery of the product or performance of the service has occurred;
- the selling price is fixed and determinable; and
- collectibility is reasonably assured.

The Company recognizes revenues from service access agreements as the service is provided, except for intercarrier compensation fees paid by our intercarrier customers for completion of their customers' calls through our network, and access charges paid by carriers for long distance traffic terminated on our network. The rights of competitive local exchange carriers (CLECs), to receive this type of compensation is the subject of numerous regulatory and legal challenges. Until this issue is ultimately resolved, the Company will continue

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

to recognize intercarrier compensation as revenue when the price becomes fixed and determinable and collectibility is reasonably assured.

Some Incumbent Local Exchange Carriers (ILECs) with which the Company has interconnection agreements had withheld payments from amounts billed by the Company under their agreements. The process of collection of intercarrier compensation can be complex and subject to interpretation of regulations and laws. This can lead to the requirement for negotiated settlements between the Company and the ILEC where it agrees to accept a portion of what it believes is owed to it. These settlements generally reflect the mutual agreements of both parties that exist at the date of the settlement. Settlements were entered into with ILECs whereby the ILECs paid the Company an aggregate of \$10.7 million in 2004, \$5.7 million in 2003 and \$20.6 million in 2002. The settlements were included in revenues.

Non-refundable up-front payments received for installation services, and related costs up to the amount of revenues, are recognized as revenue and expense ratably over the term of the service contracts, generally 36 months. Any costs in excess of recognized revenues are expensed in the period incurred. As of December 31, 2004, \$1,199,000 of installation payments received were deferred and are included in deferred revenues and \$623,000 of associated costs were deferred and are included in other assets, in the accompanying consolidated balance sheets.

*Provision for doubtful accounts receivable.* The Company estimates the provision for doubtful accounts receivable based upon the following factors:

- historical collection experience;
- customer delinquencies and bankruptcies;
- information provided by the Company's customers;
- observance of trends in the industry; and
- other current economic conditions.

Past due balances over 30 days and over a specified amount are reviewed individually for collectibility. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is remote. Collection is due and payable either upon receipt or up to 30 days from the date of invoice.

*Estimated settlements for disputed billings.* During the ordinary course of business, the Company may be billed at incorrect rates or for carrier traffic that management believes the Company is not responsible for. Accordingly, the Company will dispute the billing with the vendor and withhold payment until the matter is resolved. The Company's current disputes are primarily related to incorrect facility rates or incorrect billing elements the Company believes it is being charged. Management regularly reviews and monitors all disputed items and records an accrual that represents what it believes it may pay to settle the dispute. Although the Company continues to actively try and expedite resolutions, often times the state Public Utilities Commission becomes involved in the arbitration of these agreements. This process is often lengthy and resolutions are often subject to appeal. As of December 31, 2004, the Company accrued approximately \$1.3 million, representing managements best estimate of expected settlements of disputes currently in negotiation. If resolutions to items in negotiation are favorable or unfavorable to management's estimations, the Company's reserve for disputed items may be subject to change.

*Long-lived assets.* In 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The Company evaluates its long-lived assets if events or changes in circumstances indicate that the carrying amount of these assets may not be fully recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to the potential undiscounted cash flows expected to be generated by the asset. If

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### **PAC-WEST TELECOMM, INC.**

#### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

an asset is considered to be impaired, it is written down to its fair market value. This is assessed based on factors specific to the type of asset. In assessing the recoverability of these assets, the Company must make assumptions regarding, among other things, estimated future cash flows to determine the fair market value of the respective assets. If these estimates and the related assumptions change, the Company may be required to record additional impairment charges for these assets in the future. During the fourth quarter of 2004 and the second quarter of 2002, the Company recorded impairment charges of \$54.9 million and \$16.6 million, respectively.

#### *Other Significant Accounting Policies*

*Reclassification.* Certain prior year amounts have been reclassified to conform with the current year presentation.

*Fair Value of Financial Instruments.* The carrying value of the Company's cash and cash equivalents, marketable debt and equity securities, accounts receivable and accounts payable approximate their respective fair values due to the short-term nature of these instruments. The fair value of the Senior Secured Note approximates the value on March 11, 2005 when the Company repaid this note. The fair value of the Company's Senior Notes was based on a quotation from an investment bank as of December 31, 2004 and approximates their carrying value. The fair value of the Company's other notes payable are based on the borrowing rates currently available to the Company for bank loans with similar terms and average maturities and approximate their carrying value.

*Cash Equivalents.* The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

*Short Term Investments.* All investments with a maturity of greater than three months at the date of purchase are accounted for under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Although the Company's investment portfolio only contains investments that are highly liquid and can be converted to cash at any time, the Company determines the appropriate classification of the investment as a cash equivalent or an available-for-sale short-term investment based on the anticipated maturity date at the time of purchase. The Company's investments are not subject to penalties for early terminations or sales. All investments as of December 31, 2004 and 2003 were classified as available-for-sale and carried at fair value. Gross realized gains and losses were insignificant and included in interest income in the accompanying consolidated statements of operations. Differences between cost and fair value (unrealized gains and losses) are recorded as other comprehensive income (loss), a separate component of stockholders' equity.

*Property and Equipment.* Property and equipment is stated at cost and includes network and other communication equipment, equipment under capital leases, office furniture, business software and computer equipment, vehicles, leasehold improvements, and projects in progress. Expenditures for repairs and maintenance, which do not extend the useful life of the property and equipment and purchases below \$1,000, are charged to expense as incurred. Upon retirement, the asset cost and related accumulated depreciation are relieved from the consolidated financial statements. Gains and losses associated with dispositions and impairment of property and equipment are reflected as (income) loss on asset dispositions, net and impairment of assets, respectively, in the accompanying consolidated statements of operations. Depreciation and amortization is computed using the straight-line method. Estimated useful lives range from 3 to 20 years.

*Network expenses.* Network expenses are comprised mainly of leased transport charges, usage charges for long distance and intrastate calls and, to a lesser extent, intercarrier compensation the Company pays to other companies related to calls that originate with a Pac-West customer and terminate on the network of an ILEC or other CLEC. The Company's leased transport charges include the lease payments it incurs for the transmission facilities, or circuits, used to connect its customers to its switches and to connect to ILEC and CLEC networks. Depreciation expense associated with the Company's switching equipment is included in

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**PAC-WEST TELECOMM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --- (Continued)**

depreciation and amortization in the consolidated statements of operations. The Company does not include any significant employee costs in network expenses.

**Stock Based Compensation.** The Company follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issues to Employees" for its stock based compensation plans. The Company has adopted the disclosure-only provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," to disclose pro forma information regarding options granted to its employees based on specified valuation techniques that produce estimated compensation charges. The Company uses the Black-Scholes option-pricing model to drive theoretical fair value of employee stock option grants. These amounts have not been reflected in the Company's consolidated statements of operations because no compensation arises when the price of the employees' stock options equals the market value of the underlying stock at the date of grant, as in the Company's case. If compensation expense for the Company's stock-based compensation plans had been determined in accordance with the fair value as prescribed in SFAS 123, the Company's net (loss) income per share for the years ended December 31, 2004, 2003, and 2002 would have been as follows:

	2004	2003	2002
	(Dollars in thousands except per share amounts)		
Net (loss) income as reported	\$ (75,033)	\$ (15,250)	\$ 2,046
Total stock-based employee compensation included in reported net loss/income, net of tax	200	8	76
Total stock-based employee compensation determined under the fair value based method	(1,366)	(1,299)	(1,702)
Pro forma	\$ (76,199)	\$ (16,541)	\$ 420
Basic net (loss) income per common share:			
As reported	\$ (2.05)	\$ (0.42)	\$ 0.06
Pro forma	\$ (2.08)	\$ (0.45)	\$ 0.01
Diluted net (loss) income per common share:			
As reported	\$ (2.05)	\$ (0.42)	\$ 0.06
Pro forma	\$ (2.08)	\$ (0.45)	\$ 0.01

**Income Taxes.** The Company provides for income taxes under the asset and liability method of accounting for income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of changes in tax rates is recognized in income in the period that includes the enactment dates. Valuation allowances are provided against deferred tax assets when it is more likely than not that some portion or all of the deferred tax asset will not be realized.

**Accruals related to restructuring activities.** In June 2002 and August 2001, the Company approved and announced restructuring plans, which included, among other things, closing switch facilities in Colorado and Utah and consolidation of sales offices. In order to estimate rent expense related to these abandoned premises, the Company made certain assumptions including; (1) the time period over which the premises would remain vacant, (2) sublease terms, and (3) estimated sublease rents. In the case of the switching facilities, no sublease income was estimated due to the specialized nature these facilities. If the Company is able to sublet or negotiate an early termination penalty for its abandoned switch facility in Colorado, or is unable to sublet the sales offices within the estimated timeframe and at estimated terms, the restructuring charge could be subject to change.

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

*Recent Accounting Pronouncements*

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, "Share-Based Payment." Among other items, the standard requires the Company to recognize compensation cost for all share-based payments, in the Company's consolidated statements of operations. Depending on the model used to calculate stock-based compensation expense in the future and other requirements of SFAS No. 123R, the pro forma disclosure in Note 10 may not be indicative of the stock-based compensation expense that will be recognized in the Company's future financial statements. The new standard is effective for the first period that begins after June 15, 2005, and allows two different methods of transition. The Company is currently evaluating the new standard and models, which may be used to calculate future stock-based compensation expense.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets." SFAS No. 153 amends APB Opinion 29, "Accounting for Nonmonetary Transactions," to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. APB Opinion 29 is based on the principle that exchanges of nonmonetary assets should be measured based on fair value of the assets exchanged. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not expect the adoption of SFAS No. 153 will have a material impact on its financial position, results of operations and cash flows.

In October 2004, the FASB issued Emerging Issues Task Force Issue No. 04-8 (EITF 04-8), "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share." EITF 04-8 addresses when contingently convertible instruments should be included in diluted earnings per share. Contingent convertible instruments are instruments that have embedded conversion features that are contingently convertible or exercisable based on (a) a market price trigger or (b) multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition. The Task Force concluded that contingently convertible instruments should be included in diluted earnings per share (if dilutive) regardless of whether the market price trigger has been met. EITF 04-8 is effective for periods ending after December 15, 2004. The adoption of EITF 04-8 did not have an impact on the Company's diluted earnings per share.

In March 2004, the FASB issued EITF 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." EITF 03-1 includes new guidance for evaluating and recording impairment losses on debt and equity instruments, as well as new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting guidance provided in EITF 03-1 is effective for fiscal years beginning after September 15, 2004, while the disclosure requirements are effective for annual periods ending after September 15, 2004. The Company does not expect the adoption of EITF 03-1 will have a material impact on its financial position, results of operations and cash flows.

In December 2003, the FASB issued FASB Interpretation No. 46 (revised December 2003), "Consolidation of Variable Interest Entities," which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through means other than voting rights and accordingly should consolidate the entity. The adoption of FASB Interpretation No. 46 did not have an impact on the Company as at December 31, 2004, the Company does not believe it had any VIE's for which this interpretation would be applicable.

In December 2003, the SEC issued Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition," which codifies, revises and rescinds certain sections of SAB No. 101, Revenue Recognition, in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC

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### PAC-WEST TELECOMM, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

rules and regulations. The changes noted in SAB No. 104 did not have a material effect on the Company's financial position, results of operations and cash flows.

#### Concentration of Customers and Suppliers

During 2004 revenues from three customers accounted for 21.1%, 17.6% and 3.9% of revenues. During 2003 these same three customers accounted for 21.8%, 17.1% and 10.6% of revenues, respectively, and during 2002 accounted for 31.5%, 8.8% and 16.0%, respectively. During each of the years ended December 31, 2004, 2003 and 2002 no other customer accounted for more than 10.0% of total revenues. As of December 31, 2004 accounts receivable from one customer represented more than 10% of trade accounts receivable. In 2004, 2003 and 2002, the Company's largest source of operating costs was also one ILEC which represented 40.3%, 37.3% and 32.4% of the Company's network expenses during the years ended 2004, 2003 and 2002, respectively.

## 2. Investments

The following table summarizes the Company's investments in securities at December 31, 2004:

	Cost	Unrealized Losses, net	Fair Market Value
		(Dollars in thousands)	
U.S. government agencies	\$ 7,457	\$ —	\$ 7,457
Commercial paper	4,892	—	4,892
Corporate bonds	10,615	(114)	10,501
Total investments in securities			22,850
Cash			19,916
Total cash and investments			\$42,766
Reported as:			
Cash and cash equivalents			\$32,265
Short-term investments			10,501
			\$42,766

As of December 31, 2004, all of the contractual maturities of the Company's U.S. government agencies and commercial paper were before April 1, 2005.

The following table summarizes the Company's investments in securities at December 31, 2003:

	Cost	Unrealized Losses, net	Fair Market Value
		(Dollars in thousands)	
Commercial paper	\$27,702	\$ —	\$27,702
Cash			6,955
Total cash and investments			\$34,657

As of December 31, 2003, all of the contractual maturities of the Company's commercial paper were before February 28, 2004.



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**PAC-WEST TELECOMM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

**3. Property and Equipment**

The following tables summarize the Company's property and equipment, net at December 31, 2004 and 2003:

	2004	2003
	(Dollars in thousands)	
Network and other communication equipment	\$ 145,789	\$ 187,001
Equipment under capital leases	2,140	21,020
Office furniture	2,608	2,623
Business software and computer equipment	27,128	29,302
Vehicles	866	1,300
Leasehold improvements	16,596	21,992
Projects in Process	210	209
	<u>195,337</u>	<u>263,447</u>
Accumulated depreciation and amortization	<u>(151,924)</u>	<u>(142,236)</u>
Property and equipment, net	<u>\$ 43,413</u>	<u>\$ 121,211</u>

The Company capitalizes interest on capital projects when the project involves considerable time to implement and major expenditures. Such interest is capitalized as part of the cost of the equipment and is amortized over the remaining life of the assets. Interest is capitalized based on the Company's incremental borrowing rate during the period of asset construction. In 2004, 2003 and 2002, the Company capitalized \$0, \$65,000, and \$967,000, respectively, of interest related to capital projects.

Depreciation and amortization of property and equipment was \$32.3 million, \$43.8 million and \$40.1 million for the years ended December 31, 2004, 2003 and 2002, respectively. Depreciation and amortization is computed using the straight-line method based on the following estimated useful lives:

Equipment	3 to 7 years
Vehicles	5 years
Leasehold improvements	20 years or life of lease, whichever is shorter

During the first quarter of 2003, the Company changed its accounting estimates related to depreciation. The Company reduced the useful life for phone equipment provided to customers and computer hardware from 5 years to 3 years and extended the useful life of some leasehold improvements from 10 years to up to 20 years. As a result of the change, the Company incurred additional depreciation in the first quarter, which increased net loss for the year ended December 31, 2003 by \$1.6 million or \$0.04 per diluted share.

The Company reclassified \$1.1 million related to a technology lease from depreciation expense to selling, general and administrative expenses for the year ended December 31, 2002. In management's opinion, the new classification more accurately presents the nature of the related expense in the Company's income statement based on the underlying transaction.

**4. Impairment of Assets**

In accordance with generally accepted accounting principles, in connection with the 2004 audit of the Company's year-end financial statements, the Company tested its long-lived tangible and intangible assets to determine whether the carrying amounts of such assets were recoverable from future undiscounted cash flows. Primarily as a result of ongoing price compression and recent industry trends in the dial-up Internet access market, the Company recorded non-cash asset impairment charges of \$54.6 million for its tangible assets. In

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

performing the test, the Company determined that the total of the expected future undiscounted cash flows directly related to the existing service potential of the assets were less than the carrying value of the assets; therefore, an impairment charge was required. The Company engaged a third party valuation specialist to assist in the evaluation of the fair value of its assets using a sales comparison approach, as well as a replacement cost approach. The impairment charges represented the difference between the fair value of the property and equipment and its carrying value and are included within impairment of assets in the consolidated statements of operations. As a result of the asset impairments, a new cost basis was established for those assets that were impaired. The new cost basis resulted in a reduction of gross property and equipment and did not change the remaining estimated useful lives.

In accordance with the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets," the Company tested its goodwill and intangible assets for impairment. The Company estimated fair value using a market comparables approach that resulted in goodwill impairment charges of \$0.3 million during the fourth quarter of 2004.

5. Other Assets

At December 31, other assets consist of the following:

	2004	2003
	(Dollars in thousands)	
Deferred financing costs	\$1,038	\$1,635
Acquisition of lease rights	378	594
Long-term portion of deferred installation costs	251	311
Prepaid maintenance	587	—
Long-term portion of prepaid expenses and deposits	329	38
Intangible assets	81	—
	<u>\$2,664</u>	<u>\$2,578</u>

Deferred financing costs consist primarily of capitalized amounts for underwriter fees, professional fees and other expenses related to the issuance of the Company's debt. Amortization of deferred financing costs for the years ended December 31, 2004, 2003 and 2002 was \$703,000, \$434,000 and \$693,000, respectively, and is included in interest expense in the accompanying consolidated statements of operations. During 2004, the Company incurred an additional \$146,000 in deferred financing costs related to the Senior Secured Note transaction with Deutsche Bank AG — New York and \$100,000 in deferred financing costs related to the secured financing arrangement with Merrill Lynch Capital. During 2003 and 2002, the Company purchased from holders of its Senior Notes an aggregate of \$59.0 million and \$54.9 million principal amount of Senior Notes. In connection with these transactions, the Company expensed \$3.3 million of deferred financing costs associated with the Senior Notes redeemed. The Company also incurred additional deferred financing costs of \$5.2 million in 2003 related to the issue of the Company's Senior Secured Note.

During 1999, the Company acquired lease rights of additional space in its Los Angeles facility. This amount is being amortized on a straight-line basis over the life of the lease, which is 81 months. Amortization expense for this facility was \$216,000 for each year ended 2004, 2003 and 2002, and is included in amortization expense in the accompanying consolidated statements of operations.

In May 2004, the Company completed an agreement for maintenance with Cisco Systems, Inc. A \$1.6 million note payable was exchanged for a 36-month maintenance services agreement. This is included in the accompanying consolidated balance sheet in other current assets, other assets, and other accrued liabilities. Additionally, the related expense is included in selling, general, and administrative expense in the accompanying consolidated statements of operations.

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## PAC-WEST TELECOMM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

#### 6. Restructuring Charges

A summary of the restructuring expenses and the associated remaining liability which is included in other accrued liabilities in the accompanying consolidated balance sheet as of December 31, 2004 and 2003 consist of the following:

	Restructuring Liability as of Dec. 31, 2003	Additional Restructuring Expense Incurred	Cash Payments	Restructuring Liability as of Dec. 31, 2004
		(Dollars in thousands)		
Rent expense for vacated premises	\$2,989	\$170	\$ (695)	\$2,464
Circuit obligations	1,547	352	(1,899)	—
Other charges	6	(6)	—	—
	<u>\$4,542</u>	<u>\$516</u>	<u>\$ (2,594)</u>	<u>\$2,464</u>
	Restructuring Liability as of Dec. 31, 2002	Additional Restructuring Expense Incurred	Cash Payments	Restructuring Liability as of Dec. 31, 2003
		(Dollars in thousands)		
Rent expense for vacated premises	\$3,476	\$206	\$ (693)	\$2,989
Circuit obligations	2,800	—	(1,253)	1,547
Other charges	87	(81)	—	6
	<u>\$6,363</u>	<u>\$125</u>	<u>\$ (1,946)</u>	<u>\$4,542</u>

The Company did not approve any new restructuring plan in 2004 and 2003. The balances of the restructuring liabilities relate to restructuring plans approved in June 2002 and August 2001. The 2002 restructuring plan primarily provided for the closure of the Company's switch facility in Colorado. The 2002 restructuring plan was in response to the further weakening of the economy, additional competitive pressure from competitors who had reorganized and lowered their cost structure, overcapacity in the Company's industry and lower demand from customers for its products and services.

The 2001 restructuring plan primarily provided for the suspension of the Company's expansion plans in certain states, exiting of certain lower margin products and services (including residential resale and customer owned and maintained (COAM) equipment) and undertaking certain cost reduction initiatives. In addition to restructuring certain product offerings, the restructuring initiatives included closing the Company's switch facility in Utah, consolidation of six sales offices, and a workforce reduction of approximately 200 employees. The workforce reduction was completed during the fourth quarter, with all severance payments being made as of December 31, 2001. The 2001 restructuring plan was in response to a weakening economy and increasing competitive pressure resulting from lower than expected demand for telecommunications services and overcapacity in the Company's industry, management shifted the Company's strategy to margin improvement, cost containment and cash conservation rather than top-line growth.

The amount of the reserve for vacated premises is equal to the monthly lease payment of the unoccupied space, less any estimated sublease income, multiplied by the remaining months on the lease. In regards to the Colorado facility, no sublease income was estimated due to the specialized nature of this facility. During the second quarter of 2004, the Company recorded additional restructuring charges of approximately \$194,000 due to increased common area operating expenses at the Colorado facility. This amount was partially offset by reversals of \$37,000 of previously recorded restructuring charges related to the timing and amounts for sublease income, primarily in San Diego. During the fourth quarter of 2004, the Company recorded additional

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

restructuring charges of \$13,000 for an estimated increase in rent expense at the San Diego and San Francisco office locations. During the second and third quarters of 2004, the Company recorded additional restructuring charges of approximately \$228,000 and \$124,000, respectively, due to on-going negotiations to the amount owed for circuit commitment obligations, which the Company paid off during the third quarter of 2004. During the third quarter of 2004, the Company reversed \$6,000 of previously recorded restructuring charges related primarily to professional fees that were anticipated but not incurred. The final cash payment to be recorded against the restructuring reserve is currently expected to occur in March 2010.

During 2003, the Company recorded additional restructuring charges of \$206,000 relating to office space in San Diego, California. The amount of the reserve recorded is equal to the monthly lease payment of the unoccupied space multiplied by the remaining months on the lease. Sub-lease income was not anticipated in 2003 primarily due to economic conditions. In addition, during 2003, the Company reversed \$81,000 of previously recorded restructuring charges relating to professional fees that were anticipated but not incurred.

During the second quarter of 2002, the Company recorded a \$9.3 million restructuring charge in connection with the closure of its switch facility in Colorado. Of this amount, \$3.3 million related to the write-off of the net book value of leasehold improvements and equipment which could not be redeployed to other locations and, in management's best estimate, had a fair market value of zero; \$2.8 million related to circuit commitment obligations; and \$3.2 million related to future rent payments due for the abandoned premise in Colorado which will be paid over the lease term, which ends in fiscal year 2010. In order to estimate rent expense related to this premise, and those premises discussed in the following paragraph, the Company made certain assumptions including: (1) the time period over which the premises would remain vacant, (2) sublease terms, and (3) estimated sublease rents. In the case of the Colorado switching facility and the Utah switching facility, no sublease income was estimated due to the specialized nature of these facilities and current economic conditions. Accordingly, the Company believed the net book value of the leasehold improvements for the facilities had a fair market value of zero.

In the third quarter of 2002, the Company recorded an additional restructuring charge of \$21,000, net representing the net difference between the amount estimated and the actual net book value of impaired leasehold improvements. In the fourth quarter of 2002, the Company reduced its restructuring accrual for future rent payments for the Colorado switch facility by \$0.2 million as the Company had to use the facility longer than anticipated due to a delay in transferring one of its customers to another carrier. As of December 31, 2003, the Company had a remaining liability for this restructuring activity of approximately \$4.1 million. This lease expires in March 2010.

In the fourth quarter of 2002, the Company negotiated and paid an early termination penalty to satisfy all future rent payments due for its switch facility in Utah. Accordingly, the Company reversed previous charges of \$0.5 million to bring the accrual for this facility to zero. As of December 31, 2003, the Company had a remaining liability of \$0.4 million for this restructuring reserve.

Table of Contents**PAC-WEST TELECOMM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)****7. Other Accrued Liabilities**

At December 31, other accrued liabilities consist of the following:

	2004	2003
	(Dollars in thousands)	
Accrued restructuring charges	\$ 2,464	\$ 4,542
Accrued payroll and related expenses	3,095	2,907
Reserve for refunds to customers	98	649
General liability insurance	503	790
TelePacific Communications transaction deposits	3,500	—
Other	2,785	2,808
	<u>\$ 12,445</u>	<u>\$ 11,696</u>

**8. Debt and Capital Lease Obligations**

At December 31, long-term debt and capital lease obligations consist of the following:

	2004	2003
	(Dollars in thousands)	
Senior Notes	\$36,102	\$36,102
Senior Secured Note, net of discount of \$16,134	24,500	18,369
Capital lease obligations	1,285	2,780
Notes Payable	6,040	69
Less current portion of notes payable and capital leases	(2,889)	(2,606)
	<u>\$65,038</u>	<u>\$54,714</u>

On December 19, 2003 the Company sold to Deutsche Bank AG — New York, acting through DB Advisors, LLC, as investment advisor (Deutsche Bank), as investment advisor, in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended, a senior secured note in the principal amount of \$40.0 million, (the Senior Secured Note), and warrants to purchase up to 26,666,667 shares of its common stock at an exercise price of \$1.50 per share. The Senior Secured Note carries an interest rate of LIBOR plus 0.5% (3.02% at December 31, 2004), and matures in December 2006 (See Note 18). The maturity date of the Senior Secured Note will be automatically extended to coincide with any extension of the expiration date of the warrants, which is extendable for up to an additional 18 months at the option of Deutsche Bank. The Company allocated \$18.2 million of the proceeds of the Senior Secured Note to debt and \$21.8 million to the warrants on the basis of their relative fair values. The allocation of proceeds representing the fair value of the warrants to additional paid-in capital creates a discount on the Senior Secured Note. Under the terms of the guaranty and security agreement related to the Senior Secured Note, the Company has granted Deutsche Bank a security interest in substantially all of its assets and agreed to certain covenants including limitations on the Company's ability to incur additional indebtedness, incur liens, sell assets and pay dividends. As of December 31, 2004, the Company was in compliance with these covenants.

Accrued interest on the Senior Secured Note is payable quarterly in cash, or at the Company's option, may be capitalized and added to outstanding principal. In accordance with the terms of the Senior Secured Note, during 2004, the Company elected to capitalize and add to the outstanding principal balance interest of approximately \$0.6 million, which is reflected as a non-cash operating and financing activity in the Company's Condensed Consolidated Statement of Cash Flows. As of December 31, 2004, the principal balance was

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

\$40.6 million, the balance of the discount was \$16.1 million and the effective interest rate was approximately 30%. During 2004 and 2003, the discount amortization was \$5.5 million and \$0.2 million, respectively. The Company has amortized the discount on an effective yield to maturity basis over the life of the note. Projected interest expense on this secured note (assuming that the note is held to maturity, no interest payments are deferred and the note is not extended a full 18 months) is as follows:

	(Dollars in thousands)
2005	\$ 7,116
2006	9,016
	<hr/>
	\$16,132
	<hr/>

The Senior Notes, of which there is \$36.1 million in principal amount outstanding at December 31, 2004 and 2003, mature on February 1, 2009 and bear interest at 13.5% per annum payable in semiannual installments, with all principal due in full on February 1, 2009. In December 2003, the Company repurchased \$59.0 million principal amount of Senior Notes in a tender offer. In 2002 the Company paid approximately \$20.7 million to repurchase \$54.9 million principal amount of Senior Notes. These transactions resulted in a loss (gain) (net of the write-off of related capitalized debt issuance costs and costs paid to outside parties to complete the transaction) of \$3.7 million and \$(33.8) million in 2003 and 2002 respectively.

In conjunction with the December 2003 tender offer for Senior Notes the Company also solicited consents to effect certain proposed amendments to the indenture governing the Senior Notes. These amendments to the indenture governing the Senior Notes, which are now effective, eliminated most of the indenture's principal restrictive covenants and amended certain other provisions contained in the indenture. As of December 31, 2004, the Company was in compliance with these covenants.

During the second quarter of 2004, the Company entered into a secured financing arrangement with Merrill Lynch Capital, a division of Merrill Lynch Business Financial Services, Inc., pursuant to which the Company may borrow up to an aggregate amount of \$10.0 million, subject to certain conditions. This financing arrangement is structured in a manner that provides for multiple credit facilities up to an aggregate of \$10.0 million with each facility having separate closing dates and repayment schedules. This secured financing arrangement expired on December 31, 2004. The principal and accrued interest of each facility shall be payable in 36 equal monthly installments. The Company has the option to prepay the outstanding facility after 18 months subject to a maximum premium of 3% of the outstanding facility. Interest on each facility will be fixed at 5% plus the 3-year swap rate, as published by Bloomberg Professional Services, determined two business days prior to the closing date of each facility. The Company used the proceeds of this financing arrangement to acquire new telecommunication switch and related equipment, which secure borrowings under this financing arrangement.

As of December 31, 2004, the Company had borrowed approximately \$5.4 million under the Merrill Lynch Capital financing arrangement under two credit facilities both with interest rates of 8.6%. As of December 31, 2004, the principal balance was \$4.7 million and is included under Notes Payable in the above table. In July 2004, approximately \$2.1 million of these borrowings was paid directly to a vendor by Merrill Lynch Capital for an equipment acquisition and is reflected on the Company's Condensed Consolidated Statement of Cash Flows as a non-cash investing and financing activity.

In May 2004, the Company completed financing agreements for various network equipment with Cisco Systems, Inc. These financing agreements were comprised of \$1.4 million of equipment capital leases and a \$1.6 million note payable exchanged for a 36-month maintenance services agreement. These transactions are reflected on the Company's Condensed Consolidated Statement of Cash Flows as a non-cash investing and financing activity, and a non-cash operating and financing activity. As of December 31, 2004, the principal balance of the capital lease was \$1.1 million and is included under Capital lease obligations in the above table.

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

As of December 31, 2004, the balance of the note payable was \$1.3 million and is included under Notes Payable in the above table.

During the third quarter of 2003, the Company leased \$0.8 million of equipment over a period of 24 months. This transaction is reflected on the Company's Condensed Consolidated Statement of Cash Flows as a non-cash investing and financing activity. As of December 31, 2004, the principal balance was \$0.2 million and is included under Capital lease obligations in the above table.

As of December 31, 2004, future obligations related to Senior Notes, Senior Secured Note, Notes Payable (collectively Notes) and capital leases are as follows (projected interest on the Senior Secured Note was based on the interest rate at December 31, 2004 and not added to the outstanding principal):

	Notes	Capital Leases
	(Dollars in thousands)	
2005	\$ 8,705	\$ 747
2006	33,204	520
2007	6,281	173
2008	4,876	—
2009	36,508	—
Total minimum note and lease payments	89,574	1,440
Less: portion representing interest	(22,932)	(155)
Present value of net minimum note and lease payments	66,642	1,285
Less: short-term portion	(2,255)	(634)
Notes and capital lease obligations, long-term portion	\$ 64,387	\$ 651

9. Commitments and Contingencies

*Operating Leases*

The Company currently leases and operates seven principal facilities under non-cancelable operating leases as follows:

Facility	Lease Expiration
Stockton, California	June 2006
Stockton, California	September 2007
Oakland, California	November 2008
Los Angeles, California	September 2006
Las Vegas, Nevada	October 2009
Seattle, Washington	December 2009
Phoenix, Arizona	April 2010

The Stockton lease expiring in June 2006 has three two-year renewal options remaining and the other facility leases contain two five-year renewal options, except for Oakland, which has one five-year renewal option. The Company also leases telephone equipment sites and telephone circuits on month-to-month, annual and long-term non-cancelable leases. As the Company's leased telephone circuit commitments are fulfilled, the leases convert to month-to-month agreements. Management of the Company expects that these leases will be renewed or replaced, as necessary, by other leases in the normal course of business.

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### PAC-WEST TELECOMM, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company's restructuring programs, one approved and announced in the third quarter of 2001 and the other in the second quarter of 2002, included closing the Company's switch facilities in Utah and Colorado and the consolidation of six sales offices. All of these leases, except for the Colorado switch facility and two of the sales offices, have been terminated. The Company is subleasing both of the sales offices and continues to actively search for tenants to sublease the Colorado switch facility. Including the leases for the abandoned premises that the Company has not yet terminated less any sublease agreements in place, the Company's future minimum lease payments with initial terms in excess of one year as of December 31, 2004, are as follows:

	Operating Leases	
	Space	Telephone Circuits and Equipment
	(Dollars in thousands)	
2005	\$ 3,885	\$ 6,682
2006	3,278	3,132
2007	2,117	1,309
2008	1,444	449
2009	1,029	—
2010 and thereafter	144	—
	<u>\$11,897</u>	<u>\$11,572</u>

Rental expense charged to operations for the years ended December 31, 2004, 2003 and 2002, for operating leases for space, excluding amounts charged against the restructuring liability, was \$3.5 million, \$3.5 million and \$4.0 million, respectively. Rent expense is included in selling, general and administrative expense in the accompanying consolidated statements of operations. The Company expects to receive sublease income of approximately \$0.2 million during 2005. Rental expense charged to operations for telephone circuits of approximately \$30.0 million, \$35.2 million and \$40.4 million for the years ended December 31, 2004, 2003 and 2002, respectively, is included in network expenses in the accompanying consolidated statements of operations. Rental expense paid to related parties was approximately \$0.4 million, \$0.3 million and \$0.3 million for the years ended December 31, 2004, 2003 and 2002, respectively.

#### *Employment Agreements*

At December 31, 2004 the Company had the following employment agreements in place:

- an agreement with its Vice President and Founder created in 2004. This agreement provided for, among other things, a minimum annual base salary, fees based on services provided, benefits to be received, and job responsibilities;
- an agreement with its current President and Chief Executive Officer created in 2003. This agreement provided for, among other things, minimum annual base salaries, bonus entitlements upon the achievement of certain objectives, and the issuance of stock options;
- agreements regarding compensation and change in control with all of the Company's executive officers. These agreements provide for a lump sum payment equal to 150% of the executive's base salary, health plan benefits, and option treatment in the event of a merger or combination of the Company into another entity, or the sale or disposition of all, or substantially all, of the Company's assets; and
- an agreement with its current chairman and former chief executive officer, which provides for a minimum annual compensation level and other benefits.



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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The total annual value of the minimum base salary compensation for the agreements noted above is approximately \$0.5 million.

*Other*

From time to time, the Company is subject to audits with various tax authorities that arise during the normal course of business. The Company believes resolutions to various tax audits that the Company may be involved with in the normal course of business, will not materially harm its business, financial condition or results of operations.

*Intercarrier Compensation and Legal Proceedings*

Amounts billed to ILECs and payments withheld by ILECs during each of the three years ended December 31, 2004, 2003 and 2002 are as follows:

	2004	2003	2002
	(Dollars in thousands)		
Total amount billed to ILECs during the year	\$ 54,242	\$ 79,635	\$ 82,217
Amount withheld by ILECs and not recorded as revenue in the Company's statements of operations	(25,070)	(39,372)	(22,902)
Amounts received for prior withholding and recorded as revenue	10,650	5,685	20,596
Amounts received for prior withholding and netted against expenses	—	1,115	—
Net amount recorded as revenue from the ILECs during the year	\$ 39,822	\$ 47,063	\$ 79,911

The Company has established interconnection agreements (ICAs) with certain ILECs. The Telecommunications Act of 1996 requires ILECs to enter into ICAs with CLECs, such as the Company, and other competitors and requires state Public Utilities Commissions (PUCs) to arbitrate such agreements if the parties cannot reach agreement. The ICAs govern, among other items, intercarrier compensation agreements for the exchange of local and local toll calls between the parties.

On March 29, 2002, SBC California (SBC) filed a Petition for Arbitration with the California Public Utilities Commission (CPUC) with respect to its ICA with the Company, which would replace the similar agreement that expired in June of 2001, but which was to continue in effect until replaced. On May 8, 2003, the CPUC announced its decision to adopt a modified alternate proposal of the ICA submitted by SBC. The new three-year agreement establishes the rules under which the Company and SBC can interconnect their networks to allow for the exchange of traffic, and the recovery of costs associated with exchanging such traffic. The ICA also recognizes that SBC may implement the Federal Communications Commission (FCC) Intercarrier Internet Service Provider (ISP) order, which creates separate intercarrier compensation arrangements, including rates, terms and conditions, for "presumed ISP-bound" traffic. The Company has disputed SBC's implementation of the FCC plan. The Company and SBC settled the disputes in July 2004.

The terms of the ICA also incent the Company to modify its existing network in order to avoid new transport charges imposed by SBC. Such network modifications cause additional costs on both an ongoing and one-time basis. The agreement also authorizes the Company to charge tandem switching and transport where appropriate.

On June 12, 2002, Verizon California (Verizon) filed a Petition for Arbitration with the CPUC with respect to its ICA with the Company, that would replace the similar agreement which expired in April of 2002, but continued in effect until replaced pursuant to an order of the CPUC. On June 2, 2003, the Company

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### PAC-WEST TELECOMM, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

filed with the CPUC the new ICA with Verizon which resulted from the arbitration. The new three-year agreement establishes the rules under which the Company and Verizon can interconnect their networks to allow for the exchange of traffic and the recovery of costs associated with exchanging such traffic. In addition it includes a new transport charge applicable to certain traffic and makes the intercarrier compensation rates established by the FCC Plan effective upon the commencement of the term of the new agreement. The terms of the agreement also incent the Company to modify its existing network. Such network modifications cause additional costs to the Company on both an ongoing and one-time basis. The agreement also authorizes the Company to charge tandem switching and transport where appropriate.

In July 2003 Verizon appealed the arbitration decision of the CPUC to Federal District Court, arguing among other things that the FCC Plan rates should have been made retroactive. The Company has opposed the relief sought by Verizon, and has challenged the legality of the new transport charges imposed on certain traffic.

The Company cannot predict the outcome of future CPUC proceedings, future appeals or additional pending cases involving related issues, or of the applicability of such proceedings to its ICA with these two or other ILECs. As a result, no assurance can be given that the Company will continue to collect intercarrier compensation, which represents a significant portion of its revenues, in the future, or that additional charges may not be imposed upon the Company under such agreements in the future. ISPs currently form a significant part of the Company's customer base in California and adverse decisions in these or related FCC proceedings could limit its ability to serve this group of customers profitably and may have a material adverse effect on us.

#### *Other Legal Proceedings*

On December 6, 2001, a complaint captioned *Krim vs Pac-West Telecomm, Inc., et al.*, Civil Action No. 01-CV-11217, was filed in United States District Court for the Southern District of New York against the Company, certain executive officers, and various underwriters in connection with the Company's initial public offering. An amended complaint was filed on April 19, 2002. The plaintiffs allege that the Company and its officers failed to disclose alleged allocations of shares of the Company's common stock in exchange for excessive brokerage commissions or agreements to purchase shares at higher prices in the aftermarket, in violation of Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. Substantially similar actions have been filed concerning the initial public offerings for more than 300 different issuers, and the cases have been coordinated as *In re Initial Public Offering Securities Litigation*, 21 MC 92. The complaint against the Company seeks unspecified damages on behalf of a purported class of purchasers of its common stock. In October 2002, the executive officers of the Company were dismissed from the action without prejudice by agreement with the plaintiffs which also resulted in tolling of the statute of limitations. The court dismissed the Section 10(b) claim against the Company in 2002.

On July 10, 2003, a committee of the Company's board of directors conditionally approved a proposed settlement with the plaintiffs in this matter. The settlement would provide, among other things, a release of the Company and of the individual defendants for the conduct alleged in the action to be wrongful in the plaintiff's complaint. The Company would agree to undertake other responsibilities under the settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers who participated in the negotiation of the settlement together with insurers representing other issuers in the class action case. The committee agreed to approve the settlement subject to a number of conditions, including the participation of a substantial number of other issuer defendants in the proposed settlement, the consent of the Company's insurers to the settlement, and the completion of acceptable final settlement documentation. Furthermore, the settlement is subject to a hearing on fairness and approval by the court overseeing the litigation.

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

From time to time, the Company is a party to litigation that arises in the ordinary course of business. The Company believes that the resolution of this litigation, and any other litigation the Company may be involved with in the ordinary course of business, will not materially harm its business, financial condition or results of operations.

10. Stockholders' Equity

*Stock Options*

In January 1999, the Company's Board of Directors approved the terms of the 1999 Stock Incentive Plan (the "Plan") which authorizes the granting of stock options, including restricted stock, stock appreciation rights, dividend equivalent rights, performance units, performance shares or other similar rights or benefits to employees, directors, consultants and advisors. Options granted under the Plan have a term of ten years and substantially all options vest ratably over a four year period. In addition, options have been granted to two senior officers (both of whom are no longer officers) pursuant to the 1998 Griffin and Bryson Non-Qualified Stock Incentive Plans. In May 2000 the Board of Directors approved the 2000 Napa Valley Non-Qualified Stock Incentive Plan. At December 31, 2004 the Company had approximately 0.4 million shares available for grant under these incentive plans.

In November 2001 the Company offered to exchange options that were previously issued. As a result, in December 2001 the Company canceled 831,638 options and issued new options to eligible employees on June 18, 2002.

A summary of the status of the Company's stock option plans at December 31, 2004 and changes during the years ended December 31, 2002, 2003 and 2004 is presented in the table below:

	Shares	Weighted Average Exercise Price
	(In thousands except exercise price)	
Balance, December 31, 2001	3,879	\$3.06
Granted	1,395	0.46
Exercised	(223)	0.48
Cancelled	(492)	4.62
Balance, December 31, 2002	4,559	2.22
Granted	990	1.13
Exercised	(69)	0.49
Cancelled	(532)	3.95
Balance, December 31, 2003	4,948	1.84
Granted	372	1.63
Exercised	(86)	0.47
Cancelled	(165)	2.93
Balance, December 31, 2004	5,069	1.81

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Options outstanding, exercisable and vested by price range at December 31, 2004 are as follows:

Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Vested And Exercisable	Weighted Average Exercise Price of Options Exercisable
(Shares in thousands)					
\$ 0.27 - 0.28	142	7.7	\$ 0.28	69	\$ 0.28
0.41 - 0.60	1,613	6.9	0.50	1,145	0.49
0.66 - 0.96	1,224	7.1	0.79	1,077	0.79
1.00 - 1.48	131	9.1	1.23	24	1.22
1.59 - 2.37	1,028	6.2	2.12	708	2.13
2.53 - 3.50	397	6.6	2.74	299	2.79
4.06 - 4.29	325	5.5	4.06	324	4.06
6.25 - 9.13	13	5.8	7.68	11	7.87
10.00 - 14.75	143	4.9	10.14	143	10.14
17.50 - 25.13	49	5.4	18.66	49	18.66
31.25 - 35.00	4	5.2	33.83	4	33.83
0.27 - 35.00	5,069	6.7	1.81	3,853	2.00

As of December 31, 2003, the number of options outstanding that were vested and exercisable was 3,144,119. These options had a weighted average exercise price of \$2.19. As of December 31, 2002, the number of options outstanding that were vested and exercisable was 2,192,502. These options had a weighted average exercise price of \$2.70.

In October 2003, the Company amended certain terms, including the extension of the post termination exercise period, of previously issued options to a current officer and to a former officer and current director of the Company. Upon separation, incremental compensation cost of \$1.4 million related to each of the options held by both the chairman of the board and the chief executive officer, would be recognized over the remaining future service period of such awards.

*Pro Forma Fair Value Information*

The Company uses the Black-Scholes option-pricing model to derive the theoretical fair value of employee stock option grants.

The fair value of each option was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	2004	2003	2002
Risk-free interest rate	2.95%	2.58%	3.39%
Expected volatility	110%	108%	100%
Expected dividend yield	—	—	—
Expected life	4 years	4 years	4 years
Fair value of options granted	\$ 1.23	\$ 0.83	\$ 0.33

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**PAC-WEST TELECOMM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

***Employee Stock Purchase Plan***

The Company established the 2000 Employee Stock Purchase Plan (the Purchase Plan) under which one million shares of common stock have been reserved for issuance. Full-time employees may designate up to 10% of their compensation, not to exceed 1000 shares each six-month period, or \$25,000 worth of common stock in any one calendar year, which is deducted each pay period for the purchase of common stock under the Purchase Plan. On the last business day of each six-month period, shares of common stock are purchased with the employees' payroll deductions at 85% of the lesser of the market price on the first or last day of the six-month period. The Purchase Plan will terminate no later than May 2, 2020. During 2004 and 2003, a total of 115,359 and 77,751 shares of common stock with a weighted average fair value of \$1.12 and \$0.62 per share were purchased. At December 31, 2004, 579,695 shares remained available for issuance. Pro forma compensation cost has been computed for the fair value of the employees' purchase rights, which was estimated using the Black-Scholes model with the following assumptions: expected dividend yields of 0% for 2004, 2003 and 2002; expected life of 0.5 years for 2004, 2003 and 2002; expected volatility of 84% for 2004, 123.0% for 2003 and 100.0% for 2002 (based on the volatility period of the purchase plan); and risk-free interest rates of 1.5% for 2004, 1.1% for 2003 and 1.8% for 2002. The weighted-average fair value of those purchase rights granted in 2004, 2003 and 2002, was \$0.47, \$0.29 and \$0.20, respectively.

***Performance Unit Awards***

In December 2003, the Company granted its President and Chief Executive Officer (the CEO) the right to receive performance unit awards over 400,000 shares of common stock (before any stock split, reverse stock split or stock dividend) under an employment agreement. Under the agreement, 200,000 performance unit awards shall become vested provided the CEO remains employed by the Company through June 30, 2007 or in the event of a change in control as defined in the Company's 1999 Stock Incentive Plan. In addition, the remaining 200,000 performance unit awards will vest provided that the CEO remains employed by the Company through June 30, 2008 or in the event of a change in control as defined in the Company's 1999 Stock Incentive Plan. The agreement provides for accelerated vesting in the event that the monthly average fair market value of the Company's common stock is greater than or equal to \$3.00 per common share for a period of six consecutive calendar months commencing on or after January 1, 2004.

The Company recorded additional paid in capital and deferred stock compensation of \$768,000 (based on the Company's share price of \$1.92) on the date of these performance units were awarded. The expected cost of these shares will be reflected in income on a straight line basis over the performance period. Assuming there is no accelerated vesting of the awards the expense for 2005 is projected to be \$0.2 million. This will be included in selling, general and administrative expenses.

***Stock Warrants***

On December 19, 2003 the Company sold to Deutsche Bank (the Transaction) the Senior Secured Note. This Transaction provided, among other things, that the Company issue stock warrants to purchase up to 26,666,667 shares of its common stock at an exercise price of \$1.50 per share. See note 8 for more information. The fair value of the warrants was estimated using the Black-Scholes model with the following assumptions as of the Transaction date: expected dividend yield of 0%; expected life of three-years; expected volatility of 135%; and risk-free interest rate of 0.8%. The fair value of the warrants was \$40.5 million on the date of the Transaction, and the relative fair value was \$21.8 million (see Note 18).

***Adjustment to chairman's and executives' options***

On August 17, 2004, the Company amended the term of option grants previously awarded to its executives, including: Wayne Bell, Vice President Sales and Marketing; H. Ravi Brar, Chief Financial Officer and Vice President of Human Resources; Michael Hawn, Vice President Customer Network Services; and

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### PAC-WEST TELECOMM, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

John Sumpter, Vice President Regulatory. The amendments to the terms of the option grants previously awarded to each of the executives provided for:

- immediate vesting of all unvested stock options held by the executive in the event the executive is demoted or employment is involuntarily terminated by the Company or a successor without cause at any time during a twenty-one month period beginning nine months prior to the effective date of a possibility of a future change in control and;
- extension of the post termination period to exercise such option grants from 90 days to 365 days following termination of executive's employment. The total number of option grants previously awarded and amended was 824,000 and the total pro forma incremental compensation expense based upon the intrinsic value of the option grants previously awarded to the officers was \$117,350 on August 17, 2004.

Upon a triggering event as defined by the amendment, the Company will record incremental compensation cost related to each of the option grants awarded to the officers. There was no compensation expense recorded as of December 31, 2004.

In October 2003 the Company amended the term of options previously granted to its chairman and also to its chief executive officer. These amendments provided:

- in the case of the Company's chairman, the modification provided for (a) accelerated vesting such that each option shall be fully vested and exercisable upon termination of employment period under his employment agreement other than resignation without good cause or termination for cause and (b) to extend post termination exercise period such that it expires on the expiration date of each grant which ranges from September 2008 to December 2011. On the modification date, the Company's chairman held options to purchase 1,095,694 shares of Company common stock, which had a weighted average exercise price of \$2.49 per share and the Company's stock price was \$2.60 per share. As The Company calculated incremental compensation expense of \$1.4 million based upon the intrinsic value on the modification date. As there was no separation event as of December 31, 2004, there is no compensation expense recognized in the consolidated statement of operations for the year ended December 31, 2004 and;
- in the case of the Company's chief executive officer, the amendment provided for (a) accelerated vesting such that each option shall be fully vested and exercisable upon termination of employment period under his employment agreement other than resignation without good cause or termination for cause and (b) to extend post termination exercise period such that it expires on the expiration date of each grant which ranges from June 2011 to December 2012. On the modification date, the Company's chief executive officer held options to purchase 500,000 shares of our common stock, which had a weighted average exercise price of \$1.43 per share and the Company's stock price was \$4.31 per share. The Company calculated incremental compensation expense of \$1.4 million based upon the intrinsic value on the modification date. As there was no separation event as of December 31, 2004, there is no compensation expense recognized in the accompanying consolidated statement of operations for the year ended December 31, 2004.

#### 11. Income (Loss) Per Share

For the years ended December 31, 2004 and 2003, potential common stock was antidilutive, as it decreased the net loss per share. Accordingly, 1,910,000 and 1,265,000 shares were excluded from the diluted

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

net loss per share calculation for 2004 and 2003, respectively. Diluted net (loss) income per share information for the years ended December 31, 2004, 2003 and 2002 is as follows:

	2004	2003	2002
	(Dollars in thousands except per share amounts)		
Net (loss) income	\$ (75,033)	\$ (15,250)	\$ 2,046
Weighted average shares outstanding—basic	36,655	36,481	36,308
Effect of dilutive securities	—	—	26
Weighted average shares outstanding—diluted	36,655	36,481	36,334
Net (loss) income per share—basic and diluted	\$ (2.05)	\$ (0.42)	\$ 0.06

12. Income Taxes

The (benefit from) provision for income taxes for the years ended December 31, 2004, 2003 and 2002 consists of the following:

	2004	2003	2002
	(Dollars in thousands)		
Current:			
Federal	\$ —	\$ (949)	\$ —
State	—	(305)	77
Deferred:			
Federal	—	(3,966)	223
State	—	(1,280)	445
	\$ —	\$ (6,500)	\$ 745

The Company's (benefit from) provision for income tax differed from the amount computed by applying the statutory Federal income tax rate to income before income taxes as follows:

	2004		2003		2002	
	Amount	Rate	Amount	Rate	Amount	Rate
	(Dollars in thousands)					
Income tax determined by applying the statutory federal income tax rate to (loss) income before income taxes	\$ (26,261)	(35.0)%	\$ (7,613)	(35.0)%	\$ 977	35.0%
State income taxes, net of federal income tax benefit	(3,949)	(5.3)	(1,030)	(4.7)	339	12.2
Non-deductible amortization of costs in excess of net assets of acquired businesses	—	—	—	—	—	—
Nondeductible goodwill impairment	—	—	—	—	—	—
Valuation allowance	30,156	40.2	1,940	8.9	—	—
Changes in reserves	—	—	19	0.1	22	0.1
Other	54	0.1	184	0.8	(593)	(20.6)
(Benefit from) provision for income taxes	\$ —	—%	\$ (6,500)	(29.9)%	\$ 745	26.7%

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## PAC-WEST TELECOMM, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The cumulative balance sheet effects of deferred tax items are:

	2004	2003
Trade accounts receivable allowances	\$ 158	\$ 676
Deferred revenue	250	322
Vacation and other accrued expenses	332	356
Restructuring and other reserves	1,068	1,960
Inventory reserves	66	84
Other reserves	174	252
Tax credits and loss carryforwards	18,306	9,116
State taxes	—	1,416
Basis difference on depreciable and amortizable assets	15,275	—
Deferred tax asset	35,629	14,182
State taxes	(663)	—
Basis difference on depreciable and amortizable assets	(706)	(10,476)
Prepaid expenses	(2,164)	(1,665)
IRU rentals	(3,533)	(12,242)
Deferred tax liability	32,096	1,940
Net deferred tax asset	(32,096)	(1,940)
Valuation allowance	—	—
Net deferred tax liability	\$ —	\$ —

Management has established a valuation allowance for the portion of deferred tax assets for which realization is uncertain. The net change in the total valuation allowance for the year ended December 31, 2004 was an increase of \$30.2 million. The net change in the

As of December 31, 2004 the Company had net operating loss carryforwards for Federal and state income tax purposes of approximately \$49.9 million and \$28.0 million, respectively, available to reduce future income subject to income taxes. The Federal net operating loss carryforwards expire beginning in 2021 through 2024. State net operating loss carryforwards expire in 2014. As of December 31, 2004, unused California Enterprise Zone tax credits of approximately \$2.0 million are available to reduce future California income taxes. California Enterprise Zone tax credits carry forward indefinitely until utilized. Federal and state laws impose substantial restrictions on the utilization of net operating loss and tax credit carryforwards in the event of an "ownership change," as defined in Section 382 of the Internal Revenue Code. The Company does not believe that its utilization of net operating loss carryforwards and tax credit carryforwards should be significantly restricted.

### 13. Related Party Transactions

**Bay Alarm Company (Bay Alarm)**  
Bay Alarm (a stockholder of the Company) and its subsidiary, InReach Internet, LLC, are collectively a large customer of telephone network services, comprising approximately 1.3% of the Company's revenues for



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**PAC-WEST TELECOMM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

both the years ended December 31, 2004 and 2003. As of December 31, 2004 and 2003 the Company had amounts receivable from Bay Alarm of \$0 and \$8,000, respectively. These amounts are included in trade accounts receivable, net in the accompanying consolidated balance sheets.

The Company leases a facility in Oakland from Bay Alarm. Rents paid under this lease were \$359,000, \$334,000 and \$289,000 for the years ended 2004, 2003 and 2002, respectively. Bay Alarm provides the Company with security monitoring services at its normal commercial rates. The Company has recorded an immaterial amount (less than \$100,000) for these services in each of the years ended December 31, 2004, 2003 and 2002. All expenses paid to Bay Alarm are included in selling, general and administrative expenses in the accompanying consolidated statements of operations.

*Notes Receivable from Stockholders*

In 1998, a stockholder of the Company, who is also an officer, purchased 37,500 shares of common stock from the Company for \$250,000. The Company received \$50,000 in cash from the stockholder and entered into a note receivable for the remaining balance of \$200,000. This amount was fully repaid in 2003.

**14. Retirement Plan:**

The Company has a 401(k)-retirement plan (the Plan) for all full-time employees who have completed 90 days of service. The plan year is from January 1 to December 31, and the Company contributes \$0.50 for every \$1.00 contributed by the employee, subject to a limit of 3 percent of the employee's salary. Participants become fully vested after six years, although they vest incrementally on an annual basis after two years of service. The Company's matching contributions were \$451,000, \$303,000 and \$378,000 for the years ended December 31, 2004, 2003 and 2002, respectively. These amounts are included in selling, general and administrative expenses in the accompanying consolidated statements of operations.

**15. Segment Reporting**

Based on criteria established by SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company has determined that it has one reportable operating segment. While the Company's chief decision-maker monitors the revenue streams of various services, the revenue streams share many expenses such as leased transport charges and circuits. In addition, operations are managed and financial performance is evaluated based upon the delivery of multiple services over common networks and facilities. This allows the Company to leverage its costs in an effort to maximize return. As a result, the revenue streams share almost all of the various operating expenses. Because management believes that any allocation of the expenses to multiple revenue streams would be impractical and arbitrary, management does not currently make such allocations internally. The chief decision-maker does, however, monitor revenue streams at a more detailed level than those depicted in the Company's accompanying consolidated financial statements.

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PAC-WEST TELECOMM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The significant revenue components for the years ended December 31, 2004, 2003 and 2002 are as follows:

	2004	2003	2002
	(Dollars in thousands)		
Intercarrier compensation	\$ 39,822	\$ 47,062	\$ 79,912
Direct billings to SP customers	42,925	44,971	41,505
Direct billings to Enterprise customers	19,526	17,337	12,861
Outbound local and long distance	11,409	12,706	13,236
Dedicated transport	4,277	5,573	8,942
Switched access	5,303	6,046	7,165
Other	744	945	477
	<u>\$124,006</u>	<u>\$134,640</u>	<u>\$164,098</u>

16. Unaudited Quarterly Consolidated Financial Data

The following is a summary of quarterly consolidated financial results for the fiscal years ending 2004, 2003 and 2002.

	March 31	June 30	September 30	December 31
	(Dollars in thousands except per share amounts)			
2004:				
Revenue	\$ 29,423	\$ 27,837	\$ 31,652	\$ 35,094
Gross margin	\$ 18,931	\$ 16,689	\$ 23,117	\$ 25,435
Net loss	\$ (7,165)	\$ (9,105)	\$ (3,127)	\$ (55,636)
Net loss per share:				
Basic and Diluted	\$ (0.20)	\$ (0.25)	\$ (0.08)	\$ (1.52)
2003:				
Revenue	\$ 30,515	\$ 45,723	\$ 30,312	\$ 28,090
Gross margin	\$ 19,817	\$ 38,718	\$ 21,483	\$ 18,336
Net income (loss)	\$ (10,324)	\$ 9,171	\$ (4,314)	\$ (9,783)
Net income (loss) per share:				
Basic and Diluted	\$ (0.28)	\$ 0.25	\$ (0.12)	\$ (0.27)
2002:				
Revenue	\$ 43,092	\$ 38,499	\$ 34,201	\$ 48,306
Gross margin	\$ 29,332	\$ 24,492	\$ 21,723	\$ 35,026
Net income (loss)	\$ 7,384	\$ (13,388)	\$ 4,889	\$ 3,161
Net income (loss) per share:				
Basic and Diluted	\$ 0.20	\$ (0.37)	\$ 0.13	\$ 0.09

The fourth quarter of 2004 includes an impairment of assets charge of \$54.9 million.

The first quarter of 2002 includes a gain on extinguishment of debt of \$11.9 million.

The second quarter of 2002 includes a restructuring charge of \$9.3 million and an impairment of assets charge of \$7.2 million.

The third quarter of 2002 includes a gain on extinguishment of debt of \$14.9 million.

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**PAC-WEST TELECOMM, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

The fourth quarter of 2002 includes a gain on extinguishment of debt of \$7.0 million, an impairment of assets charge of \$9.4 million and in revenues a settlement for various disputes of \$15.8 million.

**17. Goodwill and Other Intangible Assets**

During the first quarter of 2004, the Company completed its acquisition of the assets and certain of the liabilities of Sentient Group, Inc., a small provider of fully hosted, managed voice and data services for business communications. The acquisition has been accounted for as a purchase and, accordingly, the total estimated purchase price has been allocated to the tangible and intangible assets acquired based on their respective fair values on the acquisition date. Intangible assets were recorded for the customer base in the amount of \$86,000 and is being amortized over 15 years. As of December 31, 2004, the balance of these intangible assets were \$81,000 and are recorded in other assets in the consolidated balance sheet.

The excess of the cash purchase price, \$576,000, over the fair value of tangible and intangible net assets acquired was recorded as Goodwill in the amount of \$375,000. As of December 31, 2004, the balance of goodwill was reduced to \$119,000 as a result of an asset impairment.

**18. Subsequent Events**

On March 11, 2005, the Company sold the majority of its enterprise customer base to U.S. TelePacific Corp. (TelePacific) while retaining its associated network assets. Under the terms of this transaction, TelePacific acquired certain assets and assumed certain liabilities associated with the enterprise customers in exchange for \$26.9 million in cash. In addition, the Company entered into a transition service agreement with TelePacific that, among other things, obligates it to provide certain transition services to TelePacific at its estimated cost, for a one-year period subject to extension for two additional three-month periods.

Pursuant to the terms of the Payoff Letter (the "Payoff Letter"), by and between the Company and Deutsche Bank, the Company utilized the proceeds from the sale of its enterprise customer base to TelePacific on March 11, 2005, as well as cash on hand, to prepay in full its Senior Secured Note (including all outstanding principal and accrued and unpaid interest), and retired the related warrants to acquire up to 26,666,667 shares of the Company's common stock in connection with the Senior Secured Note.

On March 11, 2005, the Company determined that, in connection with the completion of the sale of the enterprise customer base, it recorded net restructuring and other charges of approximately \$750,000, primarily consisting of employee separation costs for employees previously associated with the enterprise customer base. Out of this amount, the Company anticipates that future cash expenditures associated with the separation plan will be approximately \$300,000. This separation plan will impact approximately 150 employees, the majority of which were involuntary terminations. The Company anticipates that the majority of the employees associated with this separation plan will leave their positions by the end of 2005.

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PAC-WEST TELECOMM, INC.

SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS

(Dollars in thousands)

FOR THE YEAR ENDED DECEMBER 31, 2004

Description	Balance at Beginning of Year	Charged to Costs and Expenses	Deductions	Balance at End of Year
Allowance for doubtful accounts	\$1,560	\$ (183)	\$1,011(1)	\$366

FOR THE YEAR ENDED DECEMBER 31, 2003

Description	Balance at Beginning of Year	Charged to Costs and Expenses	Deductions	Balance at End of Year
Allowance for doubtful accounts	\$1,660	\$192	\$292(1)	\$1,560

FOR THE YEAR ENDED DECEMBER 31, 2002

Description	Balance at Beginning of Year	Charged to Costs and Expenses	Deductions	Balance at End of Year
Allowance for doubtful accounts	\$2,630	\$1,008	\$1,978(1)	\$1,660

(1) Deductions represent write-offs.